BDC
Entrepreneurs first

economic LETTER

MAY 2011

CHINA BATTLING RISING INFLATION

China's economic growth in the last three decades has been spectacular: its real GDP has grown at an average annual rate of 10% since 1980. According to the International Monetary Fund, China overtook Japan as the world's second-largest economy (measured by real GDP) in 2010 and could pass the top-ranked United States by 2016.

However, such phenomenal economic growth comes at a price. The country is now dealing with a major economic problem: rising inflation. The annual inflation rate has risen constantly since the beginning of 2010 and hit 5.4% in March 2011. China fears not just an inflationary spiral that would negatively impact its economic growth, but also and above all the social instability that rising inflation could trigger. Big increases in the cost of food and housing hit low income households hardest.

Rising inflation is the result of different factors. Poor harvests in the south of the country last summer drove food prices up. Also, like many other countries China is having to pay more for commodities in general and oil in particular. However, it is the excess liquidity in the Chinese system that is primarily responsible for the price increases, especially in housing. At the end of 2008, to counter the expected economic slowdown, the Chinese government adopted a major stimulus plan and strongly encouraged Chinese banks to lend to consumers and businesses. This resulted in an economic boom, particularly in the real estate sector, which exerted strong upward pressure on housing costs.

China's exchange rate policy has also helped to increase liquidities. In recent years China has benefited greatly from the weakness of its currency, which stimulated its exports. Under a flexible exchange rate system the yuan would have appreciated because of strong foreign demand for Chinese products. However, although China maintains a controlled floating exchange rate system,[1] in reality from 2008 to July 2010 the value of the Chinese currency was pegged to that of the U.S. dollar. To prevent the yuan from appreciating, the central bank bought billions of American dollars, which resulted in a substantial increase in the liquidities in circulation.

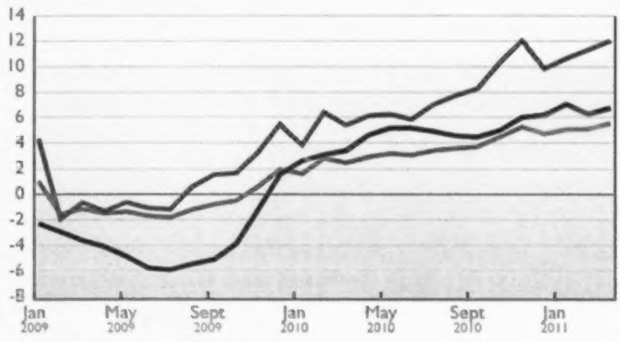
[1] Based on the average of market exchange rates, the Chinese central bank sets the yuan's daily mid-point around which it is allowed to fluctuate by 0.5% per day.

Lastly, inflation was also driven by the 20% increase in the minimum wage which the Chinese authorities brought in in 2010 to support consumer spending and ease the social tensions caused by rising prices.

The Chinese central bank has taken several steps to battle rising inflation. In July 2010 it modified its exchange rate policy and the yuan has appreciated by 5% in the past year. Also, to limit the commercial banks' ability to lend, the central bank hiked the ratio of reserves the banks are required to hold by a substantial margin and also raised the benchmark interest rates significantly.

China's inflation target for 2011 is 4% but that goal will not be easy to attain. We hope that China is successful, because sooner or later rising prices in China will impact its customers, including Canadians. We also have to hope that China will manage to gradually deflate the speculative bubble that has developed in its real estate market; the rate of growth in investments in this sector topped 30% in the first quarter of 2011. If it does not, the Middle Kingdom could experience a serious economic slowdown that would hurt the rest of the world, including Canada. ■

China: Inflation Rate



Source: Global Insight

CANADA

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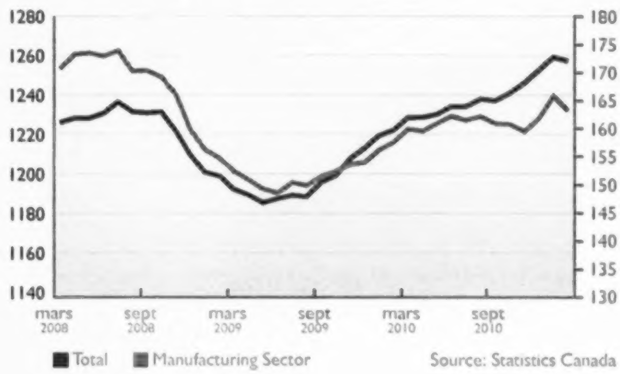
The latest figures show that the Canadian economy is doing well. GDP is progressing despite a slight dip in February, the labour market is healthy and residential construction is stronger than expected. Foreign trade is not very buoyant but business confidence is still high. However, inflationary pressures are emerging and the Bank of Canada is expected to raise its key interest rate in the near future. The jump in the price of oil and resulting appreciation of the loonie could also hobble growth.

Real GDP dips slightly

After growing 0.5% in January, real GDP dipped 0.2% in February. The manufacturing sector, where production had risen 2.8% in January from the previous month, fell back 1.6% in February. The production of vehicles and auto parts was the hardest hit. After four consecutive months of growth, wholesale trade also declined in February but this was largely offset by the increase in retail trade. Overall the GDP decline in February is not a cause for concern because it was only a small contraction after months of sustained growth. Forecasters expect growth to pick up again in the first quarter and reach 2.9% in 2011.

GDP by industry: total and manufacturing sector
(billions of chained 2002 dollars)



Source: Statistics Canada

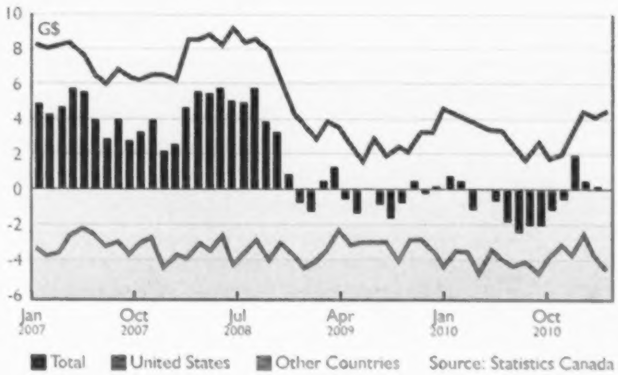
Employment picture stable

With a loss of only 1,500 jobs across Canada, employment was virtually unchanged in March. Even with this small decline 28,300 jobs were created on average over the past four months, which is more than acceptable when we consider that in the past ten years the average monthly variation was 16,000 jobs. The unemployment rate edged down from 7.8% in February to 7.7% in March. Also, the composition of the labour market improved in March: 90,600 full-time jobs were added while 92,100 part-time jobs–which are usually lower paid and more unstable than full-time jobs–were lost.

Housing market still active

Despite the decline predicted by Canada Mortgage and Housing Corporation, housing starts continued to rise. They went from 183,700 units in February to 188,800 in March, their third consecutive monthly increase. The multiple-unit housing segment, which is more volatile, accounted for much of this increase as well as starts in rural areas, while single family home starts in urban areas were down. Sales of existing homes were almost unchanged in March from February. In the first quarter 2011 they hit their highest level in a year and were 3.5% higher than in the previous quarter. Anticipation of the coming into effect of the new mortgage rules on March 18 probably triggered the increased activity in the housing market in the first quarter. If so, activity should slow in the coming quarters.

International Trade Balance



Source: Statistics Canada

Trade balance down again

A larger drop in exports than imports (-4.9% versus -4.0%) reduced the trade balance, which fell from $383 M in January to $33 M in February. The volume of exports was down in all sectors but the largest decline was in energy and automotive products. These two sectors also saw the biggest drop in the volume of imports. The trade surplus with the United States grew from $4.1 G in January to $4.6 G in February, while the trade deficit with other countries widened from $3.8 G to $4.5 G. January and February data suggest that exports will decline in first quarter 2011. ■

★ UNITED STATES

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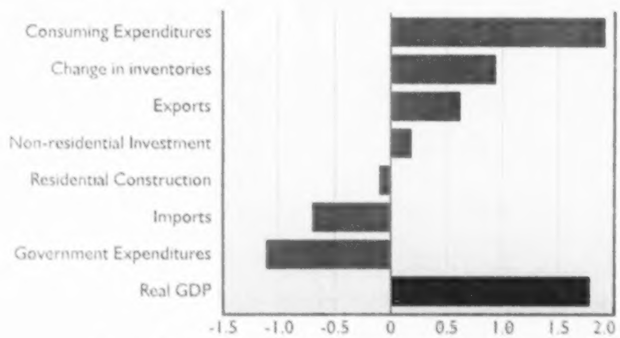
Despite slowing growth in the first quarter, the economic recovery is taking a firmer hold. Job creation is accelerating and the real estate sector is stabilizing. However, economic activity is not very robust and the outlook for growth remains uncertain because of the ill-timed jump in the price of oil resulting from ongoing instability in many Arab countries. Given the overall situation, the key interest rate should remain at its low point for many more months.

Contribution to Percent Change in Real GDP
(percentage points)



Source: Bureau of Economic Analysis, U.S. Department of Commerce

Economic growth slows

Real GDP growth went from 3.1% in fourth quarter 2010 to 1.8% in first quarter 2011. This slowdown was due to slower growth in consumer spending, non-residential investment and exports, a decline in residential investment and government expenditures, and an upturn in imports. Domestic demand grew only 0.9% in the first quarter compared to 3.2% in the previous quarter. Although far from glowing, the first quarter results are in line with the expectations of forecasters, who are predicting 2.9% growth in 2011.

Job growth finally quickens

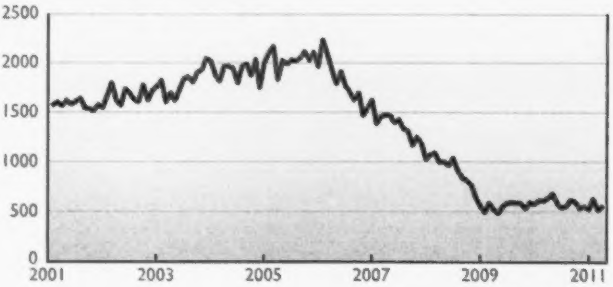
Non-farm employment increased by 216,000 jobs in March, after adding 194,000 jobs in February. The private sector gained 230,000 jobs, most of them in the service sector. From the low point in February 2010, the private sector has recovered 20% of the jobs lost during the recession. Job creation in the first quarter is very encouraging and gives reason to hope that the labour market will see a significant improvement in the coming months, which the economy really needs in order to solidify its growth.

Housing market stabilizes

Housing starts were up 7.2% in March from the previous month and building permits jumped 11.2%. Sales of existing homes rose 3.7% in March. According to the National Association of Realtors, sales have clearly resumed an uptrend but are still being held back by very tight mortgage loan conditions. When conditions return to levels similar to a decade ▼

or so ago, i.e. before extremely loose practices led to the real estate bubble, the recovery should strengthen even more. With sales of new homes rising 11.1% in March, the inventory of new homes dropped to its lowest level since 1967. Despite this good news, the housing market is still weak, as shown in the graph. ■

Residential Housing Starts
(thousands of units)



Source: U.S. Census Bureau

INTEREST RATES

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Gap between Canadian and U.S. key interest rates expected to widen soon

The Bank of Canada left its key interest rate unchanged on April 12, and the Federal Reserve did the same with its rate two weeks later. However, inflation jumped in Canada, exceeding the upper limit of the central bank's target range. The benchmark rate, which excludes the most volatile components like gasoline, stayed within the range but also increased sharply, which suggests that there are generalized upward pressures on prices in Canada. If this trend continues, the likelihood of the Canadian key interest rate being raised in the near future will grow. As things stand now, the Consensus is predicting an increase at the end of the second quarter. In the United States, economic activity is weaker and any sustained rise in inflation seems less likely. The Fed is still injecting liquidities into the economy, which means that the key interest rate is not expected to change for many more months. ■

OIL AND THE LOONIE

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Oil price continues to rise and the dollar remains strong

The price of oil continued its rise in recent weeks, soaring past US$110 a barrel, due to ongoing instability in Libya and the resulting fears among importing countries about the supply of oil. Rising oil prices drove the Canadian dollar to a record US$1.05. It is difficult to predict just how high the extremely volatile price of oil will go. However, we can expect it to remain high until the situation in Arab countries becomes more stable. ■

Crude Oil Price and Canada-U.S. Exchange Rate

Source: Global Insight

SME CONFIDENCE

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Small business leaders' confidence high but uneven

The CFIB Business Barometer Index rose to 70.7 in April, its highest level since March 2005. However, optimism among small business leaders is uneven because rising energy costs produce divergent perspectives in different regions and sectors. For example, business confidence in western Canada and Newfoundland-Labrador is higher than the national average while in the Maritimes and Quebec it is well below the average. Businesses in the transportation sector, hit hard by higher gas prices, are the least optimistic. On the other hand, despite the appreciation of the loonie, confidence remains high in the manufacturing sector. Lastly, hiring intentions are still positive and inflationary expectations are high. ■

BUSINESS CREDIT CONDITIONS

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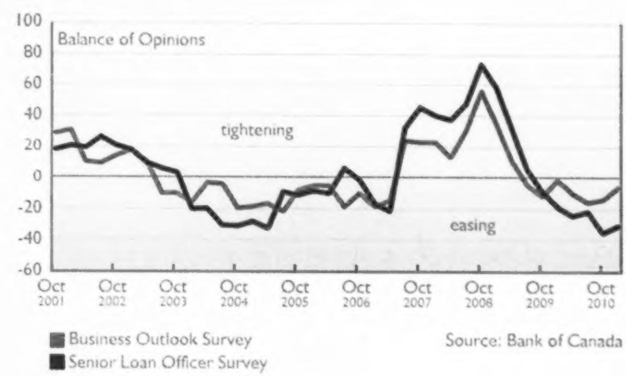
Small business credit conditions easing

In March the annual growth of business credit from chartered banks continued to rise and reached 1.4%, its highest level since May 2009. Business credit results derived from Bank of Canada surveys–Business Outlook Survey (BOS) and Senior Loan Officer Survey (SLOS)–pointed to an easing in credit conditions in the first quarter (see graph). According to the SLOS, general small business credit conditions eased for the second consecutive quarter. ■

Credit Conditions



Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2010				Latest		Forecast	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2011	2012
Real GDP (% growth)	2.2	0.5	-2.5	3.1	5.5	2.2	1.8	3.3	Feb	-0.2	2.9	2.7
Machinery and Equipment Expenditures (% growth)	4.2	-0.9	-20.3	11.2	14.8	29.7	24.6	0.7			11.3	8.2
Pre-Tax Corporate Profits (% growth)	1.9	8.0	-32.3	18.4	38.2	-6.9	0.4	41.1			13.3	8.7
Industrial Production (% growth)	-0.5	-4.5	-9.4	4.8	10.5	8.9	2.8	2.5	Feb	-0.9	4.0	3.7
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.1	3.6	1.2	-0.7	6.9	Mar	0.9	4.2	2.8
Non-Residential Construction (% growth)	2.3	7.7	-19.5	-0.5	10.6	2.4	12.7	21.0				
Housing Starts (' 000 units)	228	213	148	188	198	198	179	179	Mar	185	174	179
Personal Expenditures (% growth)	4.6	2.9	0.4	3.4	4.1	1.9	2.7	4.9			2.9	2.5
Consumer Price (% growth)	2.1	2.4	0.3	1.8	2.2	-0.1	2.4	4.4	Mar	1.1	2.4	2.1
Employment (% growth)	2.4	1.7	-1.6	1.4	1.5	3.4	1.4	0.4	Mar	0.0		
Unemployment Rate (%)	6.0	6.1	8.3	-3.1	8.2	8.0	8.0	7.7	Mar	7.7	7.6	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	68.4	66.7	64.7	66.7	May	70.7		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	69.7	69.0	65.7	70.2	May	72.3		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.